

Economic Overview

August 2014

Taking a breather

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Note from Dominick

Over the past few months just about everything relevant to the New Zealand economy has softened. Some might be tempted to view this as an important turning point in the New Zealand economic story. We don't. While this slowdown is important, we would describe it more as a "breather" in the midst of a broad and ongoing economic upswing.

As the Global Economy section explains, the current slowdown in Chinese consumer demand is serious, but will prove temporary. The Agricultural Outlook section outlines the painful impact falling dairy and log export prices will have on rural New Zealand this year, but argues that prices will start to recover towards the end of the year. The Domestic Economy section discusses a very real 'slow patch' in the domestic economic data and the housing market, but argues that these will prove fleeting. Frankly, it is hard to envisage the economy and housing market remaining weak when net immigration is set to hit an all-time high of almost 50,000 people per annum. Economic growth will remain reasonably robust for another couple of years yet, in our view.

Finally, the Inflation and Interest Rates section reminds us that the Reserve Bank's current pause is just that – a pause. We do not doubt that the RBNZ will resume its programme of OCR hikes early next year.

The New Zealand economy is on a trajectory that could one day culminate in a sustained economic downturn involving a significantly lower exchange rate, slower GDP growth, falling house prices and falling interest rates. But we don't expect that to happen until well after the Canterbury rebuild has passed its peak and interest rates have reached a level that can't be described as 'ultra low' by historical standards. By our reckoning it will be a number of years before New Zealand enters a more lasting downturn.

Dominick Stephens
Chief Economist

New Zealand Economy

Bumps and scrapes

Some of the shine has come off New Zealand's growth story in recent months, with export prices falling more than expected and some near-term loss of momentum in domestic activity. We foresee a temporary 'soft patch' in activity – not for the first time in this cycle, and not enough to cast doubt on our forecast of above-trend growth for the next two years.

As the year began, the New Zealand economy was in the midst of a sweet spot of positive factors for growth. High prices for our commodity exports were boosting farmers' incomes and had pushed the terms of trade to a four-decade high. The construction sector was powering ahead, in part due to post-earthquake rebuilding in Canterbury, but with a lift from depressed levels in other parts of the country as well. Businesses were at their most confident in two decades and increasingly willing to invest and hire. And the housing market was still buoyant enough to underpin solid growth in household spending.

The backdrop to this strong performance was a long period of low interest rates. That in turn was made possible by the economy's ability to grow without generating a significant degree of inflation pressure, (as detailed in the Inflation and Interest Rates section).

In the last few months, the balance of economic conditions has turned less positive. In particular, global supply and demand conditions have weighed on some export prices, while the Reserve Bank's interest rate hikes and lending restrictions have helped to bring down the rate of house price inflation. Recent data suggests that GDP growth over the June quarter slowed to below the 1% or so pace seen in each of the previous three quarters.

Even during boom times, the New Zealand economy rarely proceeds in a straight line. Our view is that the current slowdown will be another temporary setback, and that the economy will still achieve above-potential growth over this year and the next. A sustained slowdown is more of a prospect beyond 2016, once house prices flatten out and the Canterbury rebuild hits its peak.

There has, however, been one recent development that will be more enduring: interest rates are no longer at extremely low levels, and are set to rise further in coming years. This is a key reason why we think that, on a quarterly basis at least, GDP growth may have already seen its peak.

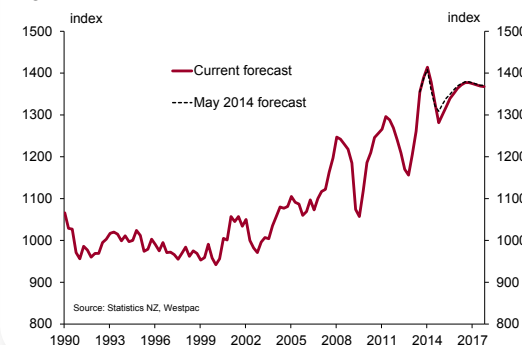
Trim milk

The biggest negative development since our last *Economic Overview* has been a further drop in world dairy prices – going beyond what we had expected in response to a sharp lift in global milk production. As we

detail in the Agricultural Outlook section, the lower dairy payout expected for this season equates to around a \$4bn drop in farm incomes. However, the impact on the wider economy should be more muted than this, as dairy farmers seem to have taken a conservative approach to last season's windfall.

With signs that global market conditions should improve by year-end, we've maintained our long-term forecast for New Zealand's terms of trade. Nonetheless, the 9% drop that we're expecting this year will inevitably have a dampening effect on growth in household spending and on-farm investment. It will also lead to a sharp widening in the current account deficit, which has been looking remarkably skinny by historical standards. While we see this as a temporary spike in the deficit, there's a risk that it won't be looked upon kindly by international investors and rating agencies.

Figure 1: Terms of trade



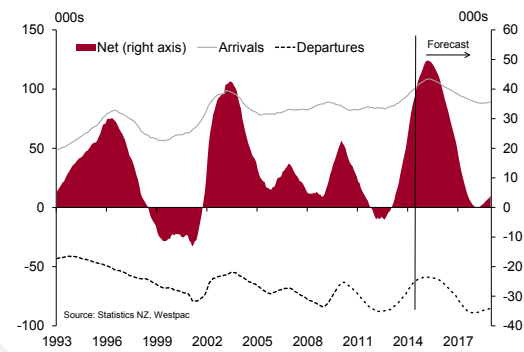
Capped

The housing market is the other major segment of the economy that has lost some momentum. Since the Reserve Bank imposed a cap on low-equity home loans last October, house sales have fallen by 17%, and annual house price inflation (on the Quotable Value measure) has slowed to 8% from a peak rate of 10% last year. This appears to have had a knock-on effect on the rate of growth in household spending since the start of the year, although the track record has been choppy from month to month.

We expect the housing market to pick up over the second half of this year – though we think it will fall short of the RBNZ’s very assertive forecasts, which would have implications for the pace of interest rate hikes. Low-equity loans are starting to move closer to the maximum 10% share of new lending, as banks become acclimatised to the restriction. The RBNZ has also said that it will review whether to loosen the limit in its November *Financial Stability Report*.

The current migration boom is another reason to expect a brief rebound in the housing market. While we’ve long emphasised that financial factors largely determine the ‘fair’ value of housing, our research also finds a role for net migration flows in predicting the short-term dynamics of house prices. We’re now expecting annual net inflows to reach just below 50,000 people by early next year, exceeding the peak in the early 2000s boom. However, we emphasise that this is a temporary trend; with the Australian jobs market turning the corner, the trans-Tasman flow of people will eventually go in Australia’s favour again.

Figure 2: Net migration to New Zealand

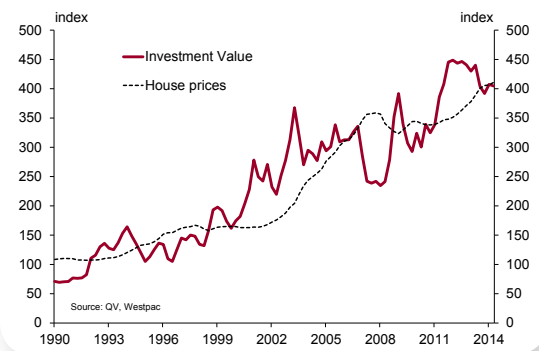


Finally, our ‘fair value’ model suggests that house prices are now more or less fairly valued. That assessment, however, rests on current fixed-term mortgage rates, some of which have actually fallen since the OCR tightening cycle began. As borrowing rates rise – and the RBNZ will likely act to ensure that they do – houses will again veer into overvalued territory, limiting the scope for further substantial price increases. We expect house prices to rise just 4.5% this year, and to effectively plateau by late 2015. We wouldn’t be surprised to see a period of falling house prices around 2016 or 2017.

Keep the home fires burning

Despite the negatives that have come through in the last few months, there are many parts of the economy that are still happily powering ahead. The construction industry had a stormer over the March quarter with a 16% lift in activity, as it played catch-up to the accumulated pipeline of consented work.

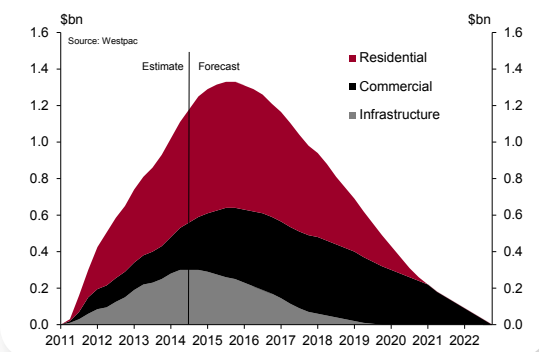
Figure 3: Investment value of housing



The Canterbury rebuild, a major aspect of the construction boom, has continued to track broadly in line with our estimates (which, by implication, would put it ahead of most official and private sector forecasts). Given this progress, we expect the value of quake-related building work to peak by the end of next year, before gradually winding down over the course of several years.

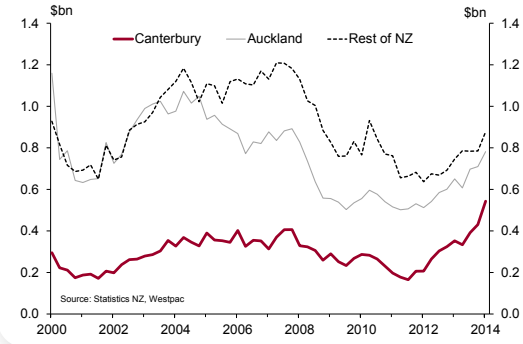
The dollar value of the work only tells part of the story. As the rebuild progresses the complexity of the work will increase, as full rebuilds overtake repairs and large CBD buildings overtake light commercial construction on the city fringes. This will present fresh challenges in terms of the building industry’s capacity; there is anecdotal evidence that shortages of certain skills are already a constraint on growth.

Figure 4: Quake-related construction (in 2012 dollars)



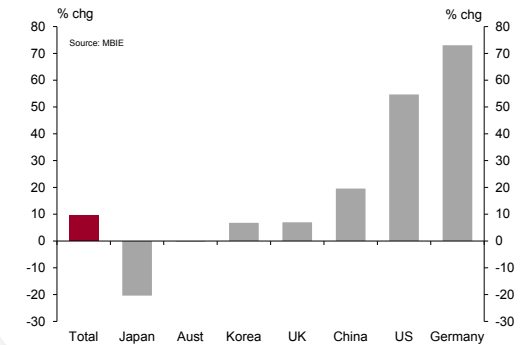
It should also be noted that the quake rebuild is not the only draw on the industry’s resources. For instance, Canterbury accounts for just over a third of the nationwide lift in new home construction in the last couple of years. But there has also been a substantial pickup in Auckland, where rising house prices and efforts to reduce red tape have provided the impetus to address the extent of under-building in recent years. Indeed, homebuilding has risen from depressed levels across the country, despite limited evidence for an under-supply of housing outside the Auckland and Canterbury regions.

Figure 5: Residential building activity (in 2012 dollars)



The tourism sector has also had a new lease of life in recent times. That may seem surprising, given the persistently high New Zealand dollar – indeed, it’s fairly clear that the rise in the NZD/AUD in the last year or so has cut into the visitor numbers from Australia. The growth in the Chinese market has been a factor, though not the dominant one; instead, the biggest increase in spending has come from more established markets such as the US and Germany. Improved marketing may have been a factor in attracting visitors who have more than simply cost in mind.

Figure 6: Growth in visitor spending, year to March 2014

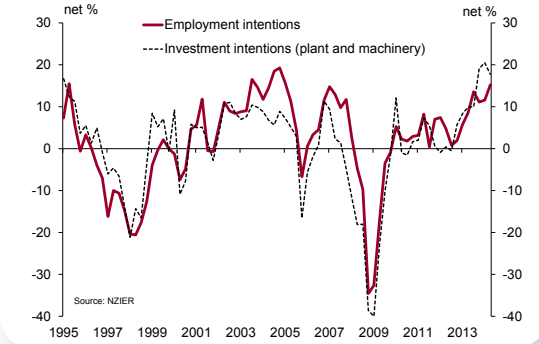


Make it work

Across a range of sectors, business confidence is at historically high levels, although it’s come off its peak since the start of the year. Moreover, firms say they are still planning to expand their capacity through investing in plant and equipment and hiring more workers – a typical delayed response to the economy’s acceleration of the last year or so. That implies we could continue to see some strong growth in job numbers even if the pace of GDP growth has already peaked.

Much of the growth in hiring to date has been accommodated by a rise in labour force participation, which hit a record high of 69.2% in the March quarter.

Figure 7: Firms’ employment and investment intentions

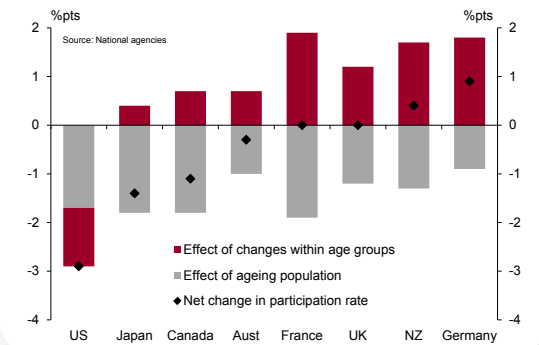


That’s an impressive achievement in itself, given that demographic trends (that is, a rising share of the population reaching retirement age) would have argued for a drop in overall participation. In New Zealand, as in other countries, a trend towards higher participation within age groups has provided some counterbalance (the US has been a notable exception).

However, New Zealand’s relatively strong performance on this front implies some unique local aspects as well. Our research suggests that rising labour force participation is due to a combination of the ‘encouraged worker’ effect arising from the economic upturn, a tightening of eligibility for welfare benefits, and a structural increase in participation among older people (unlike many countries, government superannuation in New Zealand is not means-tested, so people are not penalised for working past the retirement age).

We see scope for the participation rate to rise a bit further over the next few years, before the effects of an ageing population start to dominate. But it’s unlikely that it will continue to rise at the same pace that it has over the past year, which means that future jobs growth will increasingly have to be met from the ranks of the unemployed. In turn, that will put more upward pressure on wages than we’ve seen to date.

Figure 8: Changes in participation rates, 2007-2013



Global Economy

Opening act

Gloom is spreading among Chinese consumers, and the consequences are being felt in New Zealand. In our view, there are good reasons why this will prove temporary. That said, we don't expect Chinese consumer demand to firm up before late this year.

A theme running through the last few *Economic Overviews* has been the gradual rebalancing of global growth in favour of the US and Europe and away from emerging markets - a process with far-reaching implications for New Zealand.

One could be forgiven for thinking that this process took a big step forward in recent months. In China, the downturn has spread to the consumer sector, while US jobs growth finally developed decent momentum. We'd see that conclusion as premature. There are early signs that the Chinese economy has bottomed out, and while the US economy does seem to have grown at a decent clip last year, it will need to keep doing so to warrant rate hikes from the Federal Reserve - and on recent evidence that is still far from assured. What we've observed is the opening act, not the main event.

China

The Chinese economy is now showing signs of emerging from the slowdown it entered earlier this year. Unfortunately for New Zealand exporters, it may take longer before Chinese consumers regain their spending appetites.

The recent slowdown can be traced to the Chinese government's attempts last year to dampen what it saw as excessive investment in heavy industry and an overheating housing market, via tighter fiscal and monetary policy. The resulting drop in investment demand and loan supply left manufacturers with overstocked warehouses and prompted a flurry of

discounting. GDP growth slowed to 7.4% in the March quarter, the slowest since late 2012.

But with economic growth threatening to fall short of the government's 7% target, and inflation firmly under control, the policy reins have once again been loosened. Annual credit growth is back in positive territory, and investment in transport and utilities is expanding at a respectable pace. And manufacturers' efforts to work off their inventories appear to have made significant progress. Add an improving global economy, and the stage has been set for the Chinese economy to accelerate through the rest of the year.

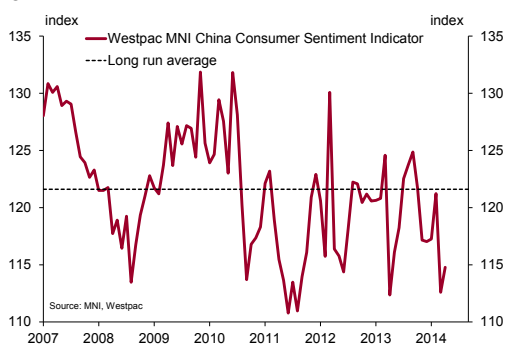
But just as it took time for the Chinese downturn to percolate through to consumers, it's likely that consumers will take a while to emerge from their current funk. The Westpac-MNI Chinese Consumer Sentiment Index - recently commissioned to help fill a big gap in China's economic data - plunged in June and has shown little improvement since. While consumers have started to feel more hopeful for the wider economy, they remain gloomy about their own finances and job prospects, and cautious about buying big-ticket items.

One reason for this is the continued shakeout in the Chinese housing market. Like Chinese manufacturers, property developers were caught on the hop by weaker demand and tighter credit, and have been aggressively offloading inventory. But in the housing market that process has further to run. House prices fell in a majority of Chinese cities in May and June, and we wouldn't be surprised to see more price weakness in coming months. Compared to previous housing cycles, there is less of an underlying housing shortage this time (though China is still far from a housing oversupply) and less willingness on the part of wealthy investors to 'buy on dips'. We expect easier monetary policy to support the housing market eventually, but we doubt Chinese consumers will be feeling perky before late this year.

US

Every time the US data get revised the growth story seems to change. On latest estimates, economic growth in 2013 was a lot stronger than previously thought - well above trend in fact, thanks to accelerating consumer

Figure 9: Chinese consumer confidence



spending and exports. Along with the significant lift in US jobs growth, that would suggest that the US upswing has become firmly entrenched.

Unfortunately, the economy seems to have slowed again this year – GDP growth in the June quarter did little more than make up for the activity lost through the cold winter. A particular drag is coming from the housing market, which slowed late last year and has only partly recovered since. That does not bode well for construction activity or consumer demand.

Impaired credit, supply issues, and low rates of household formation are all factors behind the faltering US housing market, but so is the rise in mortgage rates since the Federal Reserve first announced its intention to start ‘tapering’ its asset purchases last year. So while the Fed has reasons to feel more confident in the US economy, we think it will remain cautious about nipping the recovery in the bud by lifting interest rates too soon.

What’s more, it is still hard to make an urgent case for rate hikes on inflation grounds. Granted, unemployment is trending down, and rising food and energy costs have pushed up US headline inflation in recent months. But core inflation remains subdued, and a broader range of evidence suggests there is still a fair amount of slack in the US labour market. Workforce participation among those of prime working age remains at multi-decade lows, measures of underemployment (which include people who aren’t officially unemployed, but would work more if they could) are well above pre-recession levels, and wages are doing little more than keeping pace with inflation.

All told, while the US economy clearly gathered steam over 2013, it has yet to prove that it can maintain that pace – so the Fed is likely to stay on the side-lines for a while yet.

Australia

Developments in Australia continue to be mixed. The mining investment boom is now paying off in terms of stronger export growth, and low interest rates are boosting residential construction. But the wind-down in mining investment itself, the Chinese slowdown and the high Australian dollar are ongoing headwinds, as are government cutbacks – consumer sentiment has been fragile ever since this year’s budget.

Consumer gloom and the high AUD have prompted speculation that the Reserve Bank of Australia (RBA) would resume an easing bias. With core inflation in the top half of the RBA’s target band, that looks unlikely, but rate hikes look equally remote. We expect the cash rate to stay at 2.5% until the second half of 2015.

Europe

The European Central Bank (ECB) has backed words with action and introduced new measures to kick-start lending. These include charging banks a penalty for depositing money with the ECB; no longer sterilising the ECB’s bond holdings (in effect, leaving more cash in the system); and a ‘funding-for-lending’ scheme worth EUR400bn.

These are positive steps, but they don’t involve the central bank taking on any risk, as the US Fed did with its quantitative easing (QE) programme. For this reason we think they will do little to make lenders and businesses less cautious. The ECB is working towards a form of outright QE, but that is unlikely to go ahead before next year. In the meantime we expect growth in the euro zone to remain sluggish.

By contrast, the UK is storming ahead: GDP grew 3.1% over the year to June, the fastest since late 2007. Given the ongoing uncertainties around the US and European outlooks, we don’t expect rate hikes from the Bank of England until next year, but they will almost certainly come sooner than elsewhere.

Economic forecasts (calendar years)

Real GDP % yr	2010	2011	2012	2013	2014f	2015f
New Zealand	2.0	1.9	2.5	2.9	3.6	3.2
Australia	2.3	2.6	3.6	2.4	3.2	3.0
China	10.4	9.3	7.7	7.7	7.4	7.5
United States	2.5	1.8	2.8	2.2	1.9	2.6
Japan	4.9	-0.3	1.5	1.6	1.6	1.3
East Asia ex China	7.8	4.4	4.0	4.0	4.0	5.0
India	9.3	7.7	4.8	4.7	5.2	6.3
Euro zone	2.0	1.6	-0.6	-0.4	0.8	1.0
United Kingdom	1.7	1.1	0.3	1.8	2.6	2.1
NZ trading partners	4.8	3.6	3.6	3.5	3.9	4.1
World	5.2	3.9	3.2	3.0	3.1	3.7

Forecasts finalised 6 August 2014.

Inflation and Interest Rates

A stitch in time

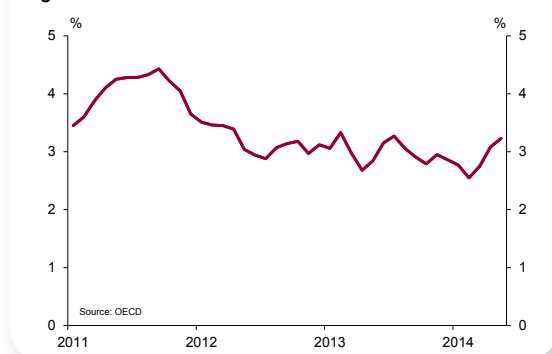
Over the past couple of years inflation in New Zealand has remained low despite an obvious acceleration in the pace of economic activity. More often than not, CPI data has surprised on the downside. It is certainly fair to question whether the Reserve Bank really will need to hike the OCR as rapidly, or as far, as we are forecasting.

A confluence of factors is responsible for today's low rate of inflation, and a few of these will persist. But the most important causes of today's low inflation will not last, and could even reverse. We remain of the view that New Zealand inflation pressures are set to intensify over the years ahead – and therefore the OCR will have to rise substantially.

All soaked up

Low inflation often arises when an economy exhibits spare capacity. When aggregate demand falls short of an economy's capacity to supply goods and services, prices have a hard time rising. At the global level, spare capacity was plentiful during the slow recovery from the 2009 recession, and this directly reduced the price of many goods and services that New Zealand imports. But global inflation has turned higher recently. With the world economy (finally) expected to gain traction in the year or two ahead, global inflation could warm further.

Figure 10: Annual inflation in the G20



In New Zealand itself, spare capacity persisted longer than otherwise courtesy of a marked acceleration in the rate of potential output growth. Rapid population growth and rising labour force participation have dramatically increased the number of people available for work, ample business investment has deepened the stock of capital, and across the economy businesses are working smarter. All of this has boosted

Figure 11: The components of potential output

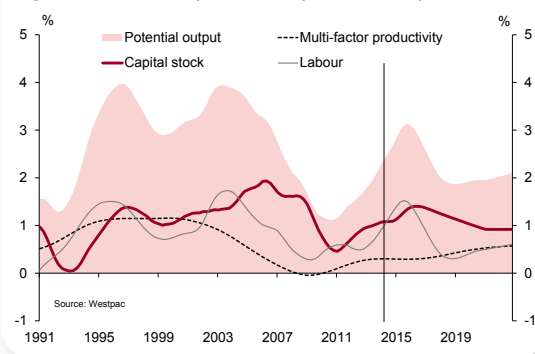
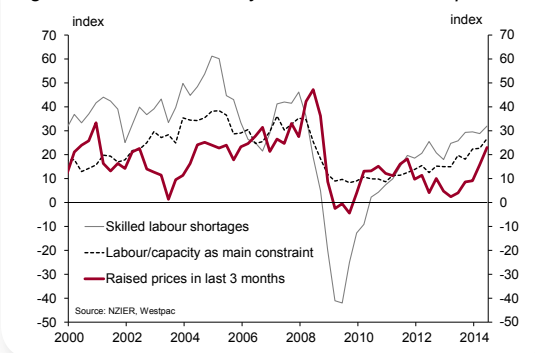


Figure 12: Business survey indicators of inflation pressure



the economy's capacity to supply goods and services. And improved supply conditions tend to limit the scope for price increases – meaning inflation has been lower than otherwise.

But even as potential output has accelerated, actual demand has accelerated even faster. This year we forecast economic growth of 3.6%, above our bullish assessment of potential output growth for the year of 2.8%. In other words, the economy is exceeding its non-inflationary speed limit, even though the speed limit is higher than it used to be. A variety of metrics show that spare capacity in the economy is being steadily used up. And as the Canterbury rebuild progresses, this output gap will widen further, putting upward pressure on inflation.

The dark side of a lower exchange rate

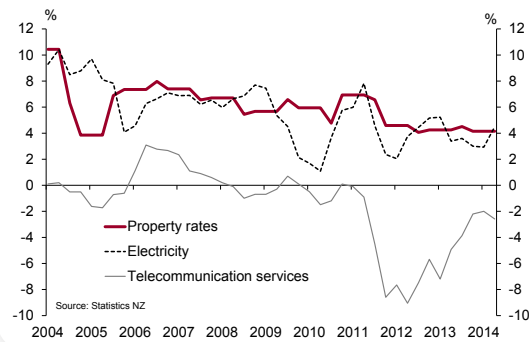
The most important cause of New Zealand's low inflation has been the rising exchange rate. The impact of the high exchange rate on retail prices has been more powerful than in decades past, probably because of internet retailing. These days, New Zealanders can leverage the power of the strong New Zealand dollar by going online to buy direct from overseas. Local retailers must compete with online prices, and so are forced to quickly pass on to consumers any benefit from the rising exchange rate.

But by our reckoning the exchange rate has already peaked, and is set to trend either sideways or down in the years ahead. In this era of online retailing, a falling exchange rate could translate very quickly into higher inflation. Australia's recent experience is instructive. The exchange rate fell sharply during 2013 and inflation soon popped up to 3%, despite subdued domestic demand.

Devil in the detail

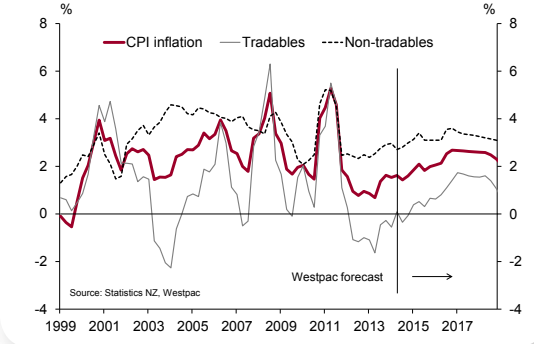
A range of special factors has also helped to keep inflation low in recent years. After an orgy of increases in local body rates last decade, councils are now under intense scrutiny to keep rate rises to a minimum. The price of communication services plunged a couple of years ago, as broadband internet prices per unit of data fell. And electricity price inflation has moderated in response to a government campaign to encourage switching away from high-price retailers. These specific factors could continue suppressing inflation in the years ahead, aided by a new special factor – lower ACC levies.

Figure 13: Annual inflation in selected items



By contrast, low rent inflation is unlikely to persist. Rents make up nine percent of the CPI, and have been increasing at only 2% per annum, despite house price inflation reaching double-digits. But net migration of 50,000 people per annum will surely boost demand for rental properties. And rising interest rates may dampen the supply of willing landlords. We expect rent increases will accelerate to around 4% per annum.

Figure 14: Inflation forecasts



Credit to the Reserve Bank

Some credit for low inflation must go to the Reserve Bank. Both Governor and Government have publicly proclaimed their strict commitment to 2% inflation, and the Reserve Bank has backed this commitment with decisive action. The consequence has been lower inflation expectations. If people expect low inflation, they will feel more comfortable with moderate wage or price settlements – and thus expectations become self-fulfilling.

The RBNZ's strict attitude will continue to influence inflation, so long as it is matched by actions. We expect the RBNZ will react vigorously to any sign of emerging inflation, and in so doing will avoid sending the OCR to a high peak. A stitch in time will save nine, so to speak.

Having already hiked the OCR from 2.5% to 3.5%, the RBNZ has paused to assess the impact on the economy. We expect this pause will last until early 2015, when a fresh spate of OCR hikes will ensue. We haven't altered our forecast for the OCR to peak at 5.25% in late 2016.

Annual Inflation and Interest Rate Forecasts

(end of quarter)

	CPI Inflation	OCR	90 day bill	2 year swap	5 year swap
Sep-14	1.4	3.50	3.70	4.20	4.60
Dec-14	1.6	3.50	3.90	4.40	4.80
Mar-15	1.8	4.00	4.20	4.60	5.00
Jun-15	2.1	4.25	4.45	4.80	5.10
Sep-15	1.8	4.50	4.65	4.90	5.20
Dec-15	2.0	4.50	4.70	5.00	5.30
Mar-16	2.1	4.75	4.95	5.10	5.35
Jun-16	2.1	5.00	5.15	5.20	5.40
Sep-16	2.5	5.00	5.20	5.20	5.40
Dec-16	2.7	5.25	5.40	5.15	5.30



Agricultural Outlook

Potholes in the road

Dairy farmers and forest owners have been caught in the downdraft of a weaker Chinese consumer. In both markets, ample supply has collided with softer demand, sending prices south. The good news is that we expect this slowdown in Chinese consumer demand to be temporary. However in the meantime, lower commodity prices and the strong NZ dollar will weigh on rural incomes.

New Zealand farmers have long understood that part and parcel of managing their business is coping with volatility in commodity markets and a fickle New Zealand dollar. Even during the good times, wise farmers will be preparing for the next downturn. Such an attitude had clearly been evident this year. Farmers responded cautiously to record highs in commodity prices, strengthening balance sheets and taking a cautious approach to new debt. Developments over the last three months, for dairy farmers and forest owners in particular, serve as a reminder of why such an attitude is so sensible.

The slide in international dairy prices, which started way back in February, accelerated in July. Importantly, we think the most recent round of price weakness is quite different to the declines we saw in March and April. Back then, falling dairy prices came as no real surprise. We'd long been warning that the combination of high prices, favourable weather conditions and low feed costs were generating a whitewash of milk in key dairying regions. What's more, an increasing proportion of this production had been making its way onto export markets.

But the further step down in prices during July was unanticipated, making it clear that increasing supply

isn't the only force at play. Instead, waning demand from China is now a prime reason for falling prices. As we note in our Global Economy section, Chinese consumers are feeling gloomy due to sluggish economic growth and falling house prices. Slower demand appears to have caught dairy wholesalers by surprise. Having apparently built up ample stocks early in the year, they've been left with extra stocks on their hands, which in turn means they haven't had to go to market to compete for fresh supplies. It was a similar story in log markets.

The good news is that we expect the situation in both markets to be temporary. Growth prospects in China have improved, and eventually this will flow through to the consumer sector. Supply and demand should move back into better balance, wholesalers will run down their stocks and as demand rallies they will need to step back into the market. Already there are reports of this process starting to happen in log markets. We also expect the usual seasonal pickup in Chinese dairy imports towards the end of the year to help bolster demand, and over a longer horizon, we remain convinced that domestic Chinese suppliers will be unable to keep pace with growth in domestic demand.

Commodity price monitor

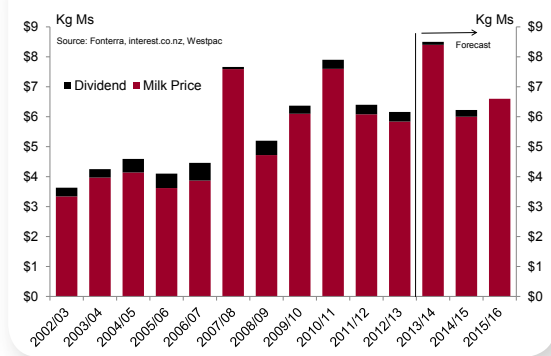
Sector	Trend	Current level ¹	Next 6 months
Forestry	Unpruned log prices have fallen sharply over the last few months on the back of a slowing Chinese housing market and a big build-up in inventories. There are now reports that inventories are starting to stabilise which should help underpin prices going forward.	Average	
Wool	Wool prices have been broadly stable over the last few months, probably underpinned by tight global supplies. Looking ahead, further improvement in developed economies should bolster demand, in contrast to the weaker outlook for the Chinese consumer.	Above Average	
Dairy	Dairy prices have slumped further in recent months under the weight of a big lift in global supply, and slowing Chinese demand. We expect prices to improve from current levels in late 2014 as demand from China recovers.	Below Average	
Lamb	Lamb prices have been broadly stable over the last couple of months. Improving demand in traditional markets should continue to support prices.	Average	
Beef	International beef prices have soared on the back of tight supplies in the US. Although this situation won't last forever, it should continue to underpin prices for a while yet.	High	

¹ NZD prices adjusted for inflation, deviation from 10yr average.

Nonetheless, recent developments are a timely reminder that while New Zealand's growing integration with China brings with it big rewards, it also comes with risks. Developments in China are now much more important for New Zealand exporters (and the New Zealand economy) than in the past.

Even factoring in a substantial recovery in dairy prices beginning in the final quarter of this year, and a fall in the NZ dollar (as detailed in the New Zealand Dollar section), we're still expecting this season's milk price payment to farmers to be well down on last year's record. We (and Fonterra) are forecasting \$6.00 per kg of milk solids – but at the time of writing a further drop in GlobalDairyTrade auction prices had created a distinct risk of an even lower payout.

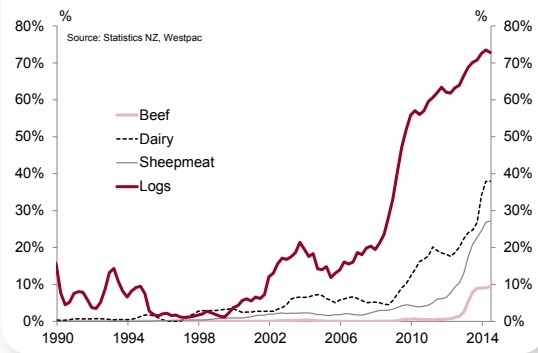
Figure 15: Fonterra payout history



But while falling dairy prices have grabbed the headlines, it hasn't all been one way traffic for New Zealand commodity exporters. In contrast to dairy and log prices, international meat prices, in particular beef prices, have made further gains. There may be a couple of reasons for this. Firstly, chilled or frozen meat is not as storable as milk powders and logs, possibly reducing the likelihood of wholesalers getting caught with a big run up in inventories. And secondly, New Zealand export markets for meat products aren't as dominated by China as dairy and log markets. While China imports almost 40% of New Zealand dairy exports and close to three quarters of log exports, it takes just 27% of lamb and sheep meat exports and a little under 10% of New Zealand's beef exports.

The other reason meat prices remain well supported is tight global supplies. The situation is most extreme in the US (New Zealand's primary beef export market). There, the cattle herd started 2014 at its lowest level since 1951. While numbers are expected to grind higher from here (incentivised by high prices, improving pastures and lower feed costs), such an extreme situation will take some time to reverse. In the meantime prices have soared and exporters from countries such as New Zealand and Australia are rushing to fill the gap.

Figure 16: Share of exports going to China



Risks to the outlook

Recent developments show that it's never smooth sailing for long in the agriculture sector and there are a number of risks on the horizon which are worth keeping an eye on. One wildcard is the weather. Forecasters sounded the alarm about a possible El Niño event earlier in the year. This has the potential to create havoc for agricultural producers around the world with some areas getting too much rain, and others too little. In New Zealand, El Niño events have sometimes been associated with droughts, and usually manifest as warmer and drier weather in northern and eastern areas, and cooler and wetter in the west and south.

But after initially warning of a severe event, forecasters are now less certain. The Australian Bureau of Meteorology has cut its assessment of the risk to 50/50 (previously it put the odds at 70%) adding that it is increasingly unlikely to be a strong event, and could occur later than initially thought. Nonetheless, given forecasting the weather is just as challenging as forecasting commodity prices, we'll keep a close eye on developments.

In dairy markets, the long-anticipated abolition of European dairy quotas is creeping closer, adding an additional layer of uncertainty. The current rules have been in place for 30 years, and when they are lifted more efficient producers such as Ireland, Germany, The Netherlands and Denmark are likely to respond by upping output. This is likely to boost European production and exports as additional processing capacity comes on stream, but it will take time.

Finally, grain prices are worthy of a mention. In the US, expectations of massive soy and corn crops are putting downward pressure on prices. For now, this is dominating any concerns about the conflict between Russia and the Ukraine interrupting exports from the Black Sea region. Falling grain prices mean reduced feed costs for Northern Hemisphere meat and dairy producers, improved margins, and an incentive to boost production – creating a risk to our forecast of high prices for New Zealand farmers.

New Zealand Dollar

A taste of reality

While a stratospheric New Zealand dollar may still have been rationalisable in June, by July it had become indefensible. As we write the NZ dollar has fallen to 85 US cents, and we expect it to fall further in coming months.

Through June and early July, the New Zealand dollar scaled new heights, rising to a new post-float high against the US dollar and also appreciating against the other majors – in spite of falling dairy prices and an increasingly disappointing tone to the New Zealand economic data.

Initially, it was possible to rationalise the strength of the Kiwi. The RBNZ had reaffirmed its commitment to OCR hikes in its June *Monetary Policy Statement*, in the face of widespread market scepticism; global financial markets had received fresh stimulus from the European Central Bank; and the drop in dairy prices could still be written off as the result of improving New Zealand and offshore production levels, rather than a sign of anything more ominous. Arguably, currency markets had looked through the drought-driven spike in dairy prices back in late 2013, and were now doing the same on the way down.

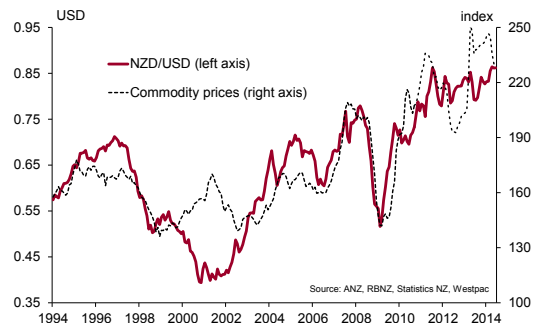
But by late July the continued decline in dairy prices was looking a lot more worrying, particularly in light of evidence of weakening Chinese consumer demand. Meanwhile the RBNZ had signalled a pause in its tightening cycle, and was railing against the exchange rate as ‘unjustified’, ‘unsustainable’ and poised ‘for a significant fall’ – a veiled threat of intervention if ever there was one.

The NZ dollar had to fall. After peaking above 88 cents in mid-June, the exchange rate is now sitting around 85 cents against the US dollar, and we expect it to weaken further in the next few months. We are forecasting an average of 83 cents over the remainder of the year.

However, we would caution against getting overly caught up in the recent doom and gloom. As we explain in the Agricultural Outlook section, there are a number of reasons to expect a sharp rebound in dairy auction prices towards the end of the year. And the Reserve Bank is on pause, not on hold – there is still a construction boom going on, and we expect the Reserve Bank to resume its hiking cycle early next year. The combination of these two developments could see the NZ dollar finding renewed favour early next year.

Over the longer term, a more sustained slide in the NZ dollar looks likely. But on our forecasts, that is a multi-year story that is unlikely to gain serious traction before late next year. Eventually, interest rates in the United States and Australia will start to rise off their lows, probably in the third quarter of 2015. We expect the Canterbury rebuild to peak at around the same time, and to start winding down in 2016. As that happens, markets will start to look forward to an eventual easing cycle from the Reserve Bank. The asynchronous nature of New Zealand’s recent economic upswing, which did so much to boost the exchange rate over the past year, will start to work in reverse.

Figure 17: NZD/USD and commodity prices, inflation-adjusted

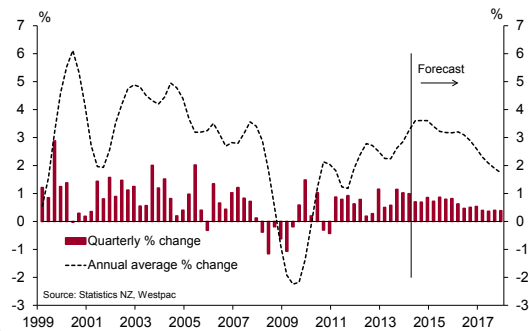


Exchange Rate Forecasts (end of quarter)

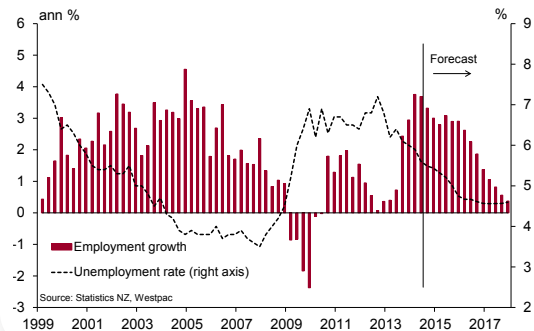
	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Sep-14	0.83	0.91	0.62	0.50	83.8	78.1
Dec-14	0.83	0.92	0.63	0.49	83.0	78.5
Mar-15	0.84	0.93	0.64	0.49	84.8	79.4
Jun-15	0.84	0.91	0.64	0.47	85.7	78.8
Sep-15	0.84	0.90	0.63	0.47	86.5	78.6
Dec-15	0.84	0.89	0.63	0.46	87.4	78.3
Mar-16	0.84	0.88	0.62	0.45	88.2	78.1
Jun-16	0.83	0.87	0.62	0.44	88.2	77.1
Sep-16	0.83	0.84	0.60	0.42	88.3	75.8
Dec-16	0.81	0.81	0.58	0.40	87.5	73.8

Annual Average % change	March years				Calendar years			
	2013	2014f	2015f	2016f	2013	2014f	2015f	2016f
GDP (production)	2.3	3.3	3.4	3.2	2.9	3.6	3.2	2.6
Private consumption	2.6	3.4	3.3	2.9	3.4	3.0	3.2	2.2
Government consumption	-1.0	1.9	1.5	0.9	1.1	2.1	0.8	1.0
Residential investment	19.3	16.9	15.4	9.0	17.3	18.5	9.4	4.1
Business Investment	3.7	8.4	8.3	7.3	7.2	6.7	9.3	3.4
Stocks (% contribution)	-0.5	0.3	0.1	-0.2	-0.1	0.4	-0.2	-0.2
Exports	2.5	0.4	2.8	1.8	0.7	4.0	0.8	1.9
Imports	1.2	7.9	7.7	3.1	6.2	7.8	4.6	1.1
Inflation (% annual)	0.9	1.5	1.8	2.1	1.6	1.6	2.0	2.7
Employment (% annual)	0.4	3.8	2.8	2.6	2.9	3.0	2.9	1.4
Unemployment rate (% s.a. end of period)	6.2	5.9	5.3	4.7	6.0	5.4	4.7	4.6
Labour cost index (all sectors, % annual)	1.7	1.6	2.2	2.6	1.6	2.0	2.5	2.7
Current account balance (% of GDP)	-3.9	-2.8	-4.5	-4.6	-3.4	-3.5	-4.9	-4.0
Terms of trade (% annual)	-2.8	17.3	-8.0	4.9	20.2	-7.8	5.5	1.9
House prices (% annual)	7.7	7.5	6.0	1.0	9.2	4.5	3.0	-2.0
90 day bank bill (end of period)	2.65	2.95	4.20	4.95	2.69	3.90	4.70	5.40
5 year swap (end of period)	3.40	4.57	5.00	5.35	4.49	4.80	5.30	5.30
TWI (end of period)	75.9	78.7	79.4	78.1	77.3	78.5	78.3	73.8
NZD/USD (end of period)	0.83	0.84	0.84	0.84	0.83	0.83	0.84	0.81
NZD/AUD (end of period)	0.80	0.93	0.93	0.88	0.89	0.92	0.89	0.81
NZD/EUR (end of period)	0.63	0.61	0.64	0.62	0.61	0.63	0.63	0.58
NZD/GBP (end of period)	0.54	0.51	0.49	0.45	0.51	0.49	0.46	0.40

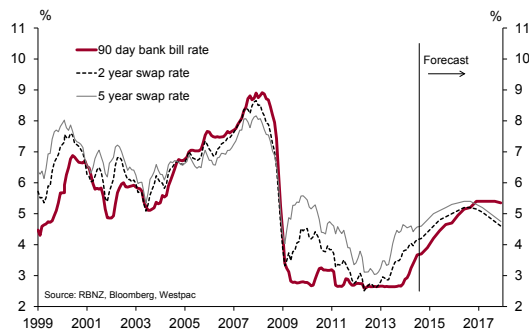
New Zealand GDP growth



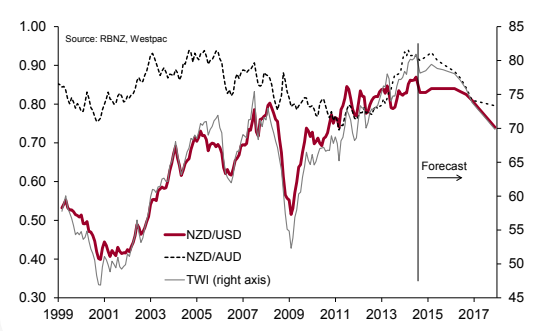
New Zealand employment and unemployment



90 day bank bill, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



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